BP EXPLORATION

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<u>Via Overnight Delivery</u>
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Minerals Management Service
Royalty Management Program, Rules and Publications Staff
Building 85
Denver Federal Center
Denver, CO 80225

RE: Department of Interior, Minerals Management Service
Notice of Reopening the Public Comment Period
Establishing Oil Value for Royalty due on Federal Leases
62 Federal Register 49460, September 22, 1997

Ladies and Gentlemen:

BP Exploration & Oil Inc., on behalf of itself and its BP Exploration (Alaska) Inc. and BP America Inc. affiliates (collectively "BP"), appreciates the opportunity to submit comments to the Minerals Management Service's ("MMS") September 22, 1997, notice ("Notice") reopening the public comment period in regard to the proposed rule published in the Federal Register on January 24, 1997 (62 F.R. 3742) and the supplementary proposed rule published on July 3, 1997 (62 F.R. 36030) that would amend the regulations governing the valuation for royalty purposes of crude oil produced from federal leases.

BP's comments addressing the alternatives set forth in the Notice appear below. These comments are in addition to those previously provided to the MMS by BP in response to the January 24 and July 3 proposed rulemakings.

<u>BP Comments on Oil Price</u>:

BP has reviewed the alternatives provided by the MMS in the Notice. We believe that royalty on oil produced from federal leases should be based on prices that most accurately reflect the gross proceeds received by the producer. The alternatives provided in the Notice provide varying degrees of accuracy.

Below is a listing of the alternatives discussed in the Notice and provided by BP in previous comments to MMS. These alternatives have been ranked from highest to lowest in their ability to accurately reflect the gross proceeds received by the producer.

- Realized price as defined in the producer's sales contract for oil sold both in arm's-length and non-arm's length transactions.
- Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of an average price developed from the producer's outright arm's length non-affiliated sales and purchase contracts for non-arm's length sales.
- Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of an average price developed from other producers' outright arm's length non-affiliated sales and purchase contracts for non-arm's length sales.
- Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of a average price developed from the RIK sales contracts for non-arm's length sales.
- Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of a netback price based on information derived from actual sales and exchange transactions from market centers and aggregation points relevant to the produced oil for non-arm's length sales.
- Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of a geographically based index price defined by the MMS or location differentials based on cents per barrel by zone/area, cents per mile by zone/area, or percentages of the NYMEX/ANS value for non-arm's length sales.
- Use of any alternative other than realized price for arm's length outright sales transactions to non-affiliated parties.

Each of the alternatives is discussed below. BP recognizes the MMS's need to assure that it is receiving full value for its royalties. Additionally, we accept the desire by MMS and producers to provide an easily administered method for both filing and audit purposes. These concerns are addressed in the discussion below.

Approach 1: Realized price as defined in the producer's sales contract for oil sold both in arm's-length and non-arm's length transactions.

<u>BP Comment</u>: The realized price as defined in the producer's sales contract is the most accurate reflection of the gross proceeds realized by the producer. All other methods use a surrogate to value the oil, and can result in a distortion of the actual realized price. To assure that the realized price is reflective of the total consideration received for the oil, the MMS should require the producer to certify that all consideration has been reflected in the price used for royalty valuation in its royalty filings.

Approach 2: Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of an average price developed from the producer's outright arm's length non-affiliated sales and purchase contracts for non-arm's length sales.

BP Comment: The use of prices developed from the producer's outright arm's length sales and purchase contracts to non-affiliated parties is a reasonable surrogate for the realized contractual price in the valuation of a producer's oil sold in non-arm's length transactions. In order to assure the validity and workability of this method, the following should be considered:

- The outright arm's length sales and purchases used in the average should be for oil from the same field with similar quality (plus/minus agreed degrees gravity and percent sulfur) and sold in similar geographic markets.
- The volume of outright arm's length sales and purchases used in the average should equal or exceed the volume of royalty oil. This will protect the MMS from having a small volume of oil sold through outright sales drive the price for a significantly higher volume of royalty oil.
- The outright arm's length sale and purchase agreements used in the average should be allowed to consist of contracts with volumes higher, lower or equal to the royalty volume. Limiting the contracts to only those equal to the royalty volume will make this option unworkable, especially in the Gulf of Mexico and Alaska where the royalty volume may become very large in the future.
- Outright arm's length sales used in the average should be allowed to be executed in a manner that the producer believes will maximize the realized price. This may include a bid-out or tendering program which involves a formal solicitation of purchase bids from the trading community and written bid responses from the prospective purchasers. Additionally, it should include the more conventional industry practice of daily informal bid and offer exchanges that occur between buyers and sellers which ultimately results in a consummated deal delineated in a formal sales contract.
- The average price developed from the producer's outright arm's length sales and purchase contracts for non-arm's length sales can be determined using either a volume weighted average or simple average. BP does not object to either approach as long as one is chosen and consistently applied.
- The producer should be required to certify that no additional consideration was received in the sales contracts used for federal royalty valuation. Additionally, the producer should be able to represent on an annual basis that the average price developed from the sales contracts falls within the range of values (or the mid-range of values if the range is large) received for all oil produced from the federal lease.

Approach 3: Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of an average price developed from other producers' outright arm's length non-affiliated sales and purchase contracts for non-arm's length sales.

BP Comment: The use of prices developed from other producers' outright arm's length non-affiliated sales and purchase contracts is a reasonable surrogate for the realized contractual price in the valuation of a producer's oil sold in non-arm's length transactions if the volume of a producer's outright arm's length sales and purchase contracts is insufficient. This approach should not be considered if the producer has sufficient volume of its own arm's length outright sales since the skills, commercial relationships, and supply volume of one producer will differ from that of another and will result in slightly differing prices.

Release on a prompt basis of sales price data from one producer to its competitors in that field would be commercially detrimental. This is especially true in markets where a producer is also a purchaser of oil from a lease. Receipt of sales price data by the purchasing producer from the other lease producers would benefit the purchasing producers' negotiating position, resulting in possible lower realized prices for the production. The MMS must put in place a system that protects price data while it is considered commercially sensitive. One approach would be to allow the producer to make a provisional royalty filing, and true up the filing with prices based on other producers' sales data at a point one year later. The economic effect of this delay should be minimal since a producer knowing its markets should be able to develop a provisional filing with prices close to the actual sales prices of its competitors.

Additionally, the considerations listed in Approach 2 should be taken into account if this approach is utilized.

Approach 4: Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of an average price developed from the RIK sales contracts for non-arm's length sales.

BP Comment: The use of prices developed from RIK contracts is a reasonable surrogate for the realized contractual price in the valuation of a producer's oil sold in non-arm's length transactions if the volume of all producers' outright arm's length sales and purchase contracts is insufficient. The RIK sale should be for oil from the same field with similar quality (plus/minus agreed degrees gravity and percent sulfur) and sold in similar geographic markets.

Approach 5: Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of a netback price based on information derived from actual sales and exchange transactions from market centers and aggregation points relevant to the produced oil for non-arm's length sales.

BP Comment: The use of a netback price based on NYMEX/ANS adjusted by market differentials would, in many cases, produce an accurate price only if the producers and MMS are willing to assume the burdensome task of filing, processing, and validating data similar to that requested in proposed Form MMS-4415. While Form MMS-4415 can be greatly simplified, the data required to allow for an accurate netback price is significant in volume and complexity. Knowledgeable staff, both within the producing companies to assure accurate filings and within the MMS to assure accurate processing and validation of the data, would be necessary to avoid audit conflict in the future.

Accuracy of the netback method is most strongly driven by the use of differential market data that is contemporaneous with the period in which the production is sold into the market. Use of prior year or even prior month data would result in netback prices that are not reflective of the value of the oil at the time of sale. For example, Gulf of Mexico production is expected to significantly increase over the next few years with the addition of new producing fields. The addition of new fields will change the supply/demand dynamics in the Gulf of Mexico and will change the commingled quality of the stream. These changes will have an affect on the relative value of the stream of crude oil represented in the NYMEX price. Accuracy can only be achieved by using differentials found in the market at the time the production would be sold into the market.

To allow for prompt filing and to protect the commercially valuable differential data requested on Form MMS-4415, the MMS should require producers to make provisional filings using their best estimates of the market differential. At a later date, when the data is no longer commercially sensitive (approximately one year later) and after the producers have had time to file Form MMS-4415 and the MMS has had time to process and validate the data, the data can be released to the producers. Producers would then be required to true-up their filings. The differences between the provisional filing and the true-up should be minimal except in those cases where the producer does not have an understanding of their market (hopefully this is rare) or where the Form MMS-4415 data was incorrectly filed or processed. In the latter case, an audit should occur to understand the discrepancy.

If administered correctly, the netback method would produce a price that closely mimics the value of the oil. Achieving that goal would require a massive amount of time, effort and personnel on the part of both the producers and the MMS. This method would result in a significant amount of audit involvement between the industry and MMS to resolve discrepancies between the Form MMS-4415 differentials and those believed to be accurate by the royalty payer. Discrepancies could only be resolved by reviewing Form MMS-4415 for accuracy of input and processing.

As stated above, the accuracy of the netback method is dependent on the accuracy of the Form MMS-4415 differentials. If Form MMS-4415 differentials are not available due to the lack of an active market (e.g., when a producer sells its production to an affiliated refinery), the MMS and the royalty payer would be required to develop a differential on limited market data. Use of a differential from the market closest in proximity for which differentials are available would lead to inaccurate prices, with inaccuracies often being as high as $1-2/bbl. MMS must have a knowledgeable staff available to evaluate these circumstances and develop more market appropriate differentials.

Approach 6: Realized price as defined in the producer's sales contract for arm's length outright sales transactions to non-affiliated parties and the use of a geographically based index price defined by the MMS or location differentials based on cents per barrel by zone/area, cents per mile by zone/area, or percentages of the NYMEX/ANS value for non-arm's length sales.

<u>BP Comment</u>: While the simplicity of these approaches is appealing, the inaccuracies of the prices derived by these approaches make them unacceptable in the markets in which BP is a participant (i.e., Gulf of Mexico and Alaska). We cannot comment on their appropriateness in the Rocky Mountain area or other areas in which we are not an active producer and marketer.

Approach 7: Use of any alternative other than realized price for arm's length outright sales transactions to non-affiliated parties.

<u>BP Comment</u>: The best reflection of the value of oil is the realized price for arm's length outright sales transactions to non-affiliated parties. Use of any other price would be less accurate.

BP is a strong believer that the accuracy of the method in determining market value is more important than administrative simplicity. BP strongly encourages the MMS to choose Approach 1, the most accurate of the approaches described above. If the MMS believes it is necessary to choose an approach different from Approach 1, we encourage you to choose the next most accurate approach. If the MMS chooses a series of benchmarks for valuing the oil, we recommend that the order of the benchmarks be set in order of declining accuracy.

BP believes that the method used for royalty valuation should reflect the average value of the oil produced from the lease. The realized price a producer receives for oil produced from a lease is typically the result of the volume weighted average of prices received in numerous sales and exchange contracts. The prices of these contracts will typically vary due to factors such as the market dynamics occurring at the different times the contracts are negotiated and the relative negotiating strength of the purchaser and producer. BP does not believe that the MMS should have the right to value royalty oil at the higher prices of the range of market prices. The method chosen by the MMS should accurately reflect the average price realized by the producer for its oil.

BP strongly opposes a method that would value oil based on the higher of a benchmark value or gross proceeds. The use of a "higher of approach" would allow the MMS to take advantage of any systematic differences between the methods and choose the higher value, which would be fundamentally inequitable to the producer. For example, a number of the methods described in the Notice would incorporate different timing in the determination of the differential or price. Assuming the two methods individually produce fair values over time, one method may produce higher values during rising markets while the other method produces higher values during declining markets. By allowing oil to be valued at the higher of alternative methods, the MMS would have the ability to take advantage of these structural timing differences, resulting in a royalty valuation for oil that would be higher than the market value.

The MMS should broaden its definition of an arm's length sale. A producer may engage in an exchange for operational reasons only. For example, due to logistical considerations in Alaska, ANS is routinely time traded between producers to allow for full loading of a tanker at Valdez. This oil is then disposed of in an outright sale. This exchange is an efficient way to transport the oil and should not affect the arm's length status of the sale. In other cases, BP exchanges its oil at one point in the transportation route for oil at another point in the transportation route and then disposes of the oil in an outright sale. Similar to the Alaskan example, this transportation exchange should not affect the sale's arm's length status.

BP encourages the MMS to provide detailed rules which would allow a producer to fully understand how to value, pay and report its royalty payments; however, there needs to be an option which allows the MMS and producers to set aside the rules and enter into a negotiated method for royalty valuation if the rules are not adaptable to the unique circumstances of a particular situation. BP specifically sees a need to address Alaskan production through a negotiated method due to the uniqueness of its transportation and marketing arrangements. Alaskan oil is commingled at or near the lease with large volumes of oil from non-federal leases. The commingled stream is transported thousands of miles through a complex system involving marine tankers and numerous pipelines. The commingled stream is sold to highly distinct pricing markets which include the U.S. West Coast, U. S. Mid-Continent, Alaska, and the Far East. The complexities of the Alaskan issues will require detailed discussions between the MMS and industry so rules can be developed which are applicable to this unique environment and which result in a fair market valuation at the lease.

BP Comments on Transportation Costs:
Allowable costs used to adjust the oil price to a wellhead price should include all costs incurred by the producer to transport the oil to the ultimate sales point. Areas of specific concern to BP involving cost include the following:

- Allowable costs should include pipeline, trucking or other physical transport cost to move the oil from the well to the market place. In a situation where a producer, or an affiliate of a producer supplies the transport system (e.g., a pipeline or tanker), the allowable cost should be reflective of the market price the producer would need to pay to a third party to move the oil. If market prices are not readily available, the producer should be able to include depreciation and a reasonable return on the full cost of the asset as allowable costs.
- Allowable costs should include any quality bank payments or receipts resulting from the commingling of different grades of crude oil that occurs during transportation through a common pipeline system.
- If the pricing basis of the crude oil is at a location other than the wellhead (e.g., as in the netback approach which uses NYMEX and ANS as the pricing basis), the MMS should recognize that a portion of that crude oil price compensates producers for the administrative and operational expenses related to the movement of the oil to the market center. MMS should allow the producer to deduct these transportation costs built into the price of the market center crude. These administrative and operational costs include costs related to personnel involved in activities such as the (1) contracting of barrel movements; (2) scheduling of the barrel movement; (3) maintenance of a sufficient crude inventory along the transportation path to allow for contractual delivery compliance; (4) compliance with environmental and safety regulations along the transportation path; and (5) gathering and analysis of samples along the transportation path to assure product integrity. These allowable costs are

transportation costs, not marketing costs, and should therefore be allowable deductions. For simplicity, we recommend that the MMS adopt a fixed cost which all producers using the netback approach or other non-wellhead based price can use in their filings to reflect the administration and operational costs related to transportation beyond the wellhead.

BP's comments to the Notice are intended to be constructive and helpful to the MMS in developing a final rule that strikes an equitable balance among the interests of all parties, and we trust that this will be the spirit in which our comments are received and considered by the MMS. BP representatives are available to clarify or provide further elaboration with regard to any of our comments should the MMS so desire.

Respectfully submitted,

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